Commission indicated that interconnection and unbundled network elements should be priced based on its TELRIC methodology "in order to encourage efficient levels of investment and entry,"[34] for competition in the local exchange. In terms of switched access, however, post-divestiture experience clearly has shown that pricing at incremental cost is not necessary for efficient entry into either the inter- or intraLATA toll markets. Therefore, the cost of rate-rebalancing or significantly increasing the size of a universal service fund if switched access is priced at TELRIC is not necessary to gain the benefit of efficient entry in the downstream inter- and intraLATA toll markets.

III. REGULATORY FLEXIBILITY IN RESPONSE TO RAPIDLY-CHANGING MARKET DEVELOPMENTS

A. Dangers of Maintaining Unnecessary Regulatory Constraints Long After Competitive Entry

In the presence of competitive entry, maintaining unneeded regulatory constraints on the ILECs has the potential of distorting market outcomes and having long-lasting deleterious effects on industry performance. As mentioned above, the exchange access market has experienced substantial competition for select customers and this competition is likely to increase as a result of increasing technological dynamics and regulatory change. Unnecessary incumbent constraints—such as universal service obligations, pricing and non-price requirements—raise incumbent costs at a time when cost reductions are essential to compete with competitors which do not have incumbent obligations such as carrier of last resort and universal service requirements. As experience in other industries indicate, maintaining unnecessary regulations on incumbents long after competitive entry has occurred causes economic harm to the incumbent provider, consumers and the economy as a whole. In such an

[34]Interconnection Order ¶ 672.

environment the least-cost provider may be foreclosed from providing service and thus reducing productive and allocative efficiencies.

Examples in other industries indicate the dangers and costs to society in delaying regulatory changes and eliminating unnecessary regulatory constraints. In a recent paper, Dr. Robert G. Harris estimates the cost to the freight transportation industry of maintaining excess capacity in the form of routes which did not cover their own costs to be in the range of $3.4 billion and $15.4 billion in 1995 dollars.[35] Dr. Harris estimates that there was a $1.6 billion per year net gain in railroad profitability (in 1977 dollars) and consumers gained an estimated $3.62 billion per year (in 1977 dollars) as a result of recent Congressional deregulatory actions.[36]

Dr. Harris also measures the economic harm incurred by the banking industry in the presence of asymmetric regulation and competitive entry. While banks were subject to interest rate restrictions, universal service restrictions under the Community Reinvestment Act, or line of business and geographic restrictions, competitors from nonbank financial service providers—such as insurance companies Prudential and Met Life, brokers like Merrill-Lynch and E.F. Hutton and large corporations like AT&T and Ford Motor Company—were not subject to the same amount of regulation. According to the American Bankers Association the above requirements, coupled with many additional regulatory and compliance rules, cost the industry $10.7 billion in 1991.[37]

Sound economics and examples from the freight and banking industries indicate that maintaining unnecessary regulatory constraints on incumbents leads to significant societal costs. Regulatory policies must be based on current market developments and, given the rapid

[35]Robert G. Harris, "Toward Regulatory Symmetry in Local Exchange Services: Lessons From Financial Services and Freight Transportation," Presented to the Industrial Organization Society Allied Social Science Associations, San Francisco, January 5, 1996.

[36]In 1980, Congress passed the Staggers Act to deregulate the railroad industry and the Motor Carrier Act to deregulate the trucking sector.

[37]Robert G. Harris, "Toward Regulatory Symmetry in Local Exchange Services: Lessons From Financial Services and Freight Transportation," *Op. Cit.*, p. 29.

changing environment of telecommunications, on likely future development as well. Regulation must not be based on a monopoly-provided system which no longer is present or relevant.

B. Market Determinants of Regulatory Flexibility

A principal goal of regulatory policy in introducing competition in an industry characterized by a sole provider should be to reduce, to the greatest extent possible, unnecessary asymmetric obligations on the incumbent provider. Pursuing such a policy ensures that a provider's efficiencies and relative abilities to supply customer demands determine success in the market—not regulatory distortions. Therefore, regulation must not only prevent the exercise of market power by the incumbent but must simultaneously regulate the incumbent and entrants as symmetrically as possible in all other dimensions.

Modern economic theory does not reveal a bright line in deciding when a service is open to sufficient market forces that prevent non-transitory and significant price increases above the competitive level for a sustained period of time. However, there are guidelines that can be used in deciding when to reduce regulatory constraints and the degree to which they can be reduced. It is important to note that rules for reducing regulatory constraints be based on actual state experience as opposed to artificial criteria established by the Commission that may not be approved in the states. Basing rules on the latter possibility fails to take into account real market dynamics and penalizes ILECs by maintaining unneeded regulatory constraints. In addition, we believe that tying regulatory relief to full implementation of universal service—something beyond the ILEC's control—is not appropriate and also fails to respond adequately to market openings. There are access services in some geographic areas that should be exposed to significantly less regulatory constraints today, independent of universal service implementation.

USTA's transition plan for streamlining regulatory constraints reflects the competitive nature of the market and provides sufficient protection to prevent the exercise of market power.

USTA's approach is a market-based approach which we believe to be far superior to any prescriptive reform mechanism. Under USTA's approach, a state-approved interconnection agreement or Statement of Generally Available Terms is sufficient to obtain Phase I relief. In Phase I, services—on a statewide basis—remain under price cap regulation with a simplified basket structure, volume and term discounts, contract tariffs, elimination of Part 69 codification and deregulation of new services. Phase II focuses on a geographic basis and would require a demonstration of actual competition by one or more carriers, including an interconnection agreement and corresponding use of unbundled elements, facilities-based competition or resale. It is appropriate that the Commission analyze and evaluate the number of competitors, the targeted serving area, measurements of minutes of use exchanged, and NXX codes assigned to competitors as indicators that competition is present and operating in the market area. At this stage, services are removed from price cap regulation because market forces are sufficient to constrain price increases.

1. Phase I: Access services likely to face competitive alternatives in the near term

The first changes in regulation are intended to eliminate unnecessary regulatory constraints which do not reward efficiency and prevent the least-cost supplier from providing the service. This change should occur when the market is *first* opened to competitors so that entrants and incumbents will make efficient entry and exit decisions, some of which entail large investments and sunk costs. At this stage, regulation should be immediately adjusted so that it provides neither the entrant nor the incumbent any net advantage on a forward-looking basis. In order for competitors to be given accurate and efficient price signals, they must compete with firms on as a symmetric basis as possible. By adopting this approach, entrants are given accurate market signals which lead to entry in those instances where their economic costs of providing the service are less than or equal to the incumbent's economic costs—net unneeded regulatory constraints. This avoids uneconomic bypass and ensures that the service is being

provided by the firm that is capable of producing it at the lowest economic cost—thus ensuring productive efficiency.

USTA's proposal for implementing Phase I once a state-approved interconnection agreement or a Statement of Generally Available Terms becomes effective is consistent with sound economics. Therefore, the Commission should immediately reform current regulatory constraints by: (i) consolidating price cap basket and service categories and eliminating Part 69 codification; (ii) deaveraging switched access service rates by geographic area and class of customers; (iii) authorizing ILECs to offer volume and term discounts; (iv) authorizing ILECs to offer contract tariffs and responses to RFPs; and (v) deregulating new services.

a. Phase I Trigger

To obtain Phase I relief, the proponent must show; (i) all significant regulatory and legal entry barriers have been removed; and (ii) timely entry is possible at current prices. The Telecommunications Act of 1996 removes the legal barriers to entry in the exchange access market and a state-approved interconnection agreement or a Statement of Generally Available Terms is sufficient evidence to indicate that regulatory, legal and operational entry barriers have been removed—thus requiring a removal of unneeded regulatory constraints.

In addition to examining the removal of regulatory and legal barriers sound economics require that timely entry is possible at current prices. In measuring the effect of entry on market power the *Merger Guidelines* of the Department of Justice and Federal Trade Commission consider two effects. First, "other firms not currently producing or selling the relevant product in the relevant area [are treated] as participating in the relevant market if their inclusion would more accurately reflect probable supply responses."[38] Such firms must be likely to enter profitability within one year in response to a small but significant margin

[38]The U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992, § 1.32, p. 20-21.

between market price and cost and without any expenditure of significant sunk costs of entry. Second, over a longer period, the *Guidelines* consider "the timeliness, likelihood, and sufficiency of the means of entry...a potential entrant might practically employ."[39]

For purposes of obtaining Phase I relief, our analysis is only used to establish the likelihood of entry, not its ability to affect market prices. Entry in the *Guidelines* would be considered likely if it would be profitable at premerger prices which could be realized by an entrant.[40] Hence, we would grant Phase I relief if an existing firm that is currently not in the market could enter within a two year period and expect to make a profit at current prices. The existence of unbundled elements coupled with resale allow for rapid entry and must be taken into account when applying the *Guidelines*. In addition to network elements, resale and existing facilities-based providers, potential entrants in diverse industries will be able to take advantage of access to the incumbent's network and provide additional checks on market power.

Interconnection agreements and Statements of Generally Available Terms contain provisions which dramatically reduce economic barriers to entry and reduce the costs of entry. These provisions include interconnection, access to unbundled elements, resale, collocation and reciprocal compensation. This—combined with the removal of operational barriers to entry—has the effect of significantly reducing a competitor's sunk cost investment needed to enter the market. In modern economic theory, sunk costs of entry are the key to measuring barriers to entry as part of a market power analysis. A sunk cost is a cost that must be incurred to enter a market and cannot be recovered if the firm elects to leave the market. The sunk costs incurred to enter the local exchange market—although varying on a geographic and class of customer basis—is significant. It is likely that the most obvious example is in the requirement to dig up streets and lay down cable or build poles and string wires. It is unquestionable that in addition

[39] *Ibid.*, § 3, p. 50.

[40] *Ibid.*, §§ 3.2, 3.3 and 3.4.

to the 1996 Act, coupled with the Interconnection Order, a state-approved interconnection agreement or a Statement of Generally Available Terms reduces the absolute level of sunk cost needed to enter the market. Competitors are able to lease network elements on a month to month basis and obtain access to rights of ways reducing sunk costs and facilitating various entry strategies.

In addition, whereas in the past access customers were able to bypass ILEC access services through self-supply or obtaining alternative CAP services, an interconnection agreement has the effect of increasing not only alternatives to traditional ILEC access services but also the scope. In essence, an interconnection agreement or Statement of Generally Available Terms facilitates competitive entry in a greatly expanded area by making it economical for competitors to compete in areas that may have been unremunerative—for reasons such as insufficient density and volume to warrant facilities investment—prior to passage of the Act. For these reasons, regulatory flexibility in Phase I should be implemented on a statewide basis to enhance and improve entry signals. Regulatory changes make competition in expanded areas likely and efficiency improvements are required to ensure that the least cost provider provide the service.

For theses reasons, USTA's proposal to require pricing flexibility on a state-wide basis in light of state-approved interconnection agreements or Generally Available Terms is appropriate and sound economics. Because it reduces unneeded asymmetrical obligations *after* competition has been authorized USTA's proposal provides ample protection. A state-approved interconnection agreement or Statement of Generally Available Terms is evidence that competitors are likely to enter the market or have increased ability to enter the market—even in areas that previously would not have been served by them. Therefore, in order for prices to impart efficient entry-decision signals, a potential competitor must compare its economic cost of providing service with the incumbent's economic costs—absent unneeded regulatory constraints. Not permitting the incumbent carrier to compete on as symmetrical

terms as possible ensures a higher level of resource expenditure than would otherwise have been the case.

b. Phase I Reforms

USTA's reform for phase I services include: (i) consolidation of price cap basket and service categories and elimination of Part 69 codification; (ii) deaveraging switched access service rates by geographic area and class of customers; (iii) authorizing ILECs to offer volume and term discounts; (iv) authorizing ILECs to offer contract tariffs and responses to RFPs; and (v) deregulating new services. At this stage of market development, it is essential that asymmetric regulatory constraints be reduced to the greatest possible extent. It is important that this condition be met not only for the tangible productive efficiencies generated—as mentioned above—but also for the benefits gained by those remaining customers both wholesale and retail. Asymmetric pricing constraints in the carrier access market raises the effective cost in the complementary retail service. That is, competition in carrier access and retail are likely to be simultaneous and complementary; obtaining an access customer dramatically increases the likelihood of capturing the end user. In a regulated environment, uneconomic bypass increases pressure on rate increases for remaining customers who would have benefited had the departing customer remained and contributed to fixed costs.

USTA's proposal for consolidation of price cap basket and service categories and elimination of Part 69 codification enhances economic efficiency by improving ILECs ability to respond to competitive market developments. The new price cap basket reduces administrative costs and accurately reflects changing market conditions. Creation of a new basket with four service categories—Tandem Switching and Transport, Local Switching, Data Base Services and Common Line—coupled with service category price constraints and zone-level price constraints reduces market power leveraging. In addition, as mentioned above, interconnection agreements that provide for the availability of unbundled elements, interconnection, access to rights of way, etc., provide additional consumer protection to constrain price increases. Access

to network elements on a timely basis—as afforded by electronic bonding requirements—constrains the ability of the ILEC to leverage market power and provides adequate protection.

Deaveraging access service rates by geographic area and class of customers more closely aligns rates with the way ILECs incur costs and lead to efficiency improvements. Deaveraging rates by geographic area enhances economic efficiency by sending improved price signals and leads to improved utilization of telecommunications facilities. This is especially important in the early stages of competitive alternatives because efficient entry decisions should be made on the basis of economic cost. Restricting deaveraging flexibility artificially impedes efficient competition by not accurately depicting the true economic costs incurred and increasing the likelihood of uneconomic bypass. In addition, as network elements are deaveraged it becomes imperative to permit ILEC deaveraging so as to provide optimal levels of network element and facilities-based competition. Deaveraging is consistent with competitive markets and should be left to market dynamics to determine the optimal amount. In addition, deaveraging should occur regardless of the amount or degree of market forces—thus ensuring accurate signals.

Permitting ILECs price flexibility to respond to competitive alternatives leads to improvements in resource allocation and efficiency. Volume and term discounts, contract tariffs and responses to RFPs promote efficient utilization of telecommunication resources by more closely aligning customer preferences with the firm's per-unit costs for production or delivery of large orders. Customer heterogeneity in access demand implies that benefits arise in being able to meet customers' valuation of successive increments of the quantity purchased.

The Courts, the Commission, and economic principles have recognized that permitting a firm to reduce or restructure prices to retain customers or service volumes that it would otherwise lose to competitors would result in *lower* prices for all consumers, provided only that services were always priced above incremental cost. The reason is simple: at any price above incremental cost, every sale covers its own costs and provides some amount of contribution towards fixed and common costs of the firm. Other customers and other services do not bear

"excessive and unreasonable prices" because of ILEC volume or term discounts or customer-specific pricing; on the contrary, prices for other ILEC services could be reduced if market-based pricing—above incremental cost—permits ILECs to retain business that it would otherwise lose to a competitor. Indeed, volume and term discounts and customer-specific prices and service configurations are normal and healthy consequences of competition in markets where customers have widely different needs for services. Efficiency requires that competitors *and* ILECs be able to respond to rapidly changing and idiosyncratic demands and preferences.

Given the rapidly changing and dynamic telecommunications environment, it is essential that incentives to develop and market new services not be reduced by unneeded regulatory constraints that artificially increase costs but fail to provide meaningful consumer benefits and/or protection. Therefore, it is appropriate that the Commission eliminate all requirements that an ILEC obtain regulatory approval before a tariff introducing a new service can take effect, as long as core access service offerings are available. We believe that this—coupled with the availability of network elements—provides for sufficient protection and that the potential benefits in incentive improvements outweigh any potential costs.

2. Phase II: Market Forces Sufficient to Constrain Prices

A service can be classified as a Phase II service if market forces are sufficient to prevent an incumbent from maintaining price above the competitive level. Deciding that a service is ready for removal from current price cap regulation presents more difficult economic and public policy considerations. Placing a service in the Phase II category indicates that market forces are sufficient to constrain prices. USTA's proposal which removes a service from price cap regulation after a *measurable* amount of competitive alternatives are available on a geographic area basis is consistent with sound economics and provides for sufficient consumer protection. The proposal is appropriate given current market conditions and errs on the side of caution because the availability of unbundled network elements substantially reduces barriers to entry in the carrier access market.

In addition, while resale competition by itself is unlikely to capture the full benefits of dynamic competitive markets, the carrier access market is somewhat distinct. Unbundled element competition is likely to have a greater efficiency-improvement impact on the carrier access market than in the retail market due to the absolute level of carrier access rates and its inefficient rate-design structure. A greater reliance—than otherwise would be the case—on the availability of unbundled network elements as a tool to discipline prices is warranted in the case of carrier access. USTA's Phase II is a conservative approach because: (i) it relies on the additional condition that there exist a measurable amount of competition; and (ii) its focus is on a geographic area basis. By focusing on a geographic basis, USTA's proposal accurately takes into account the heterogeneity of competition and permits ILECs to respond to competition where it is actually occurring and still provide sufficient consumer protection for customers who are not yet exposed to an intensity of market forces sufficient to constrain prices.

a. Phase II Trigger

For firms to exercise market power, two conditions must hold: (i) there must be little competition from existing firms producing substitutes for the service in question; and (ii) entry into the market by new competitors must be difficult. The Commission must decide what would be the effect on demand served by the incumbent firm if it initiated a small but significant and non-transitory increase in price above the competitive level. Would a sufficient number of customers substitute away from the regulated firm's service so that the price increase would result in lower—rather than higher—profits?

While market concentration is a proper starting off point for evaluating alleged market power, care must be taken, however, not to equate market share with market power. Any measure of market concentration generally depends on market share which can be measured in terms of output, revenues, or productive capacity. As recognized by the Commission in its Non-Dominant Order, for network-based telecommunications markets, the appropriate measure

of size is generally capacity.[41] If rivals have capacity in place that can be brought on line at low additional cost so that the customer has a real choice of suppliers, the LEC cannot exercise market power. Therefore, if market share is large, the service can still be classified as a Phase II service if: (i) functionally equivalent substitutes for its service can be shown to be generally available at comparable prices; or (ii) market share is falling over time and market demand is likely to grow in the future.

After an analysis of current competition, attention must turn to conditions of entry into the market. Absent barriers to entry, any elevation of price above the competitive level would attract entry, expand market demand and reduce the market price towards the competitive level. Entry barriers, therefore, are a necessary condition for market power. The *Merger Guidelines* standards are appropriate to measure the extent to which potential entry disciplines prices in the market.

As mentioned above, firms not currently offering the service in the relevant geographic area would be treated as part of the market "if their inclusion would more accurately reflect probable supply responses," measured over a one-year horizon from the date of the opportunity to enter.[42] In addition, potential entry would be expected to affect market prices only if it passed the additional tests of likelihood, timeliness and sufficiency. Likelihood was defined above as a firm not currently in the market being able to enter within a two-year period and expect to make a profit at current prices. Timeliness is defined in the *Guidelines* as a two-year window from initial planning to the point at which the entrant could offer services in the market while sufficiency asks if entry can occur at a sufficient scale to maintain prices at their competitive level in all relevant geographic and product market niches.

A thorough analysis of entry conditions must include evaluation on the extent of sunk costs of entry. In evaluating market power, sunk costs of entry are key to measuring barriers to

[41] *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, Order, 11 FCC Rcd 3271, 3357, 1995.

[42] *Merger Guidelines*, § 1.32, p. 20-21.

entry. Sunk costs are defined as costs that must be incurred to enter a market but which cannot be recovered if the firm elects to leave the market. Competitors can enter and exit the industry at relatively low costs to take advantage of any profitable opportunities in the market if sunk costs are not important requirements of entry. Therefore, to assess the conditions of entry in the relevant market, the Commission should (1) analyze the extent of legal and regulatory barriers to entry and (2) characterize the degree to which entry (or exit) would entail commitment of sunk costs for potential entrants. When obvious entry barriers can not be found, the best evidence regarding the condition of entry can come from (3) an examination of the history of the market, observing patterns over time of entry and exit, market growth, and changes in market share. Indeed, if entry has taken place at all, entry barriers can not have been insurmountable.

Therefore, to classify a service in the Phase II category the Commission should ask the following: (i) is the degree of competition from firms currently in the market sufficient to prevent the incumbent from profitably holding price above the competitive level?; and (ii) are barriers to entry sufficiently low so that entry from new competitors would prevent an incumbent from maintaining price above the competitive level? If either of the two questions are answered in the affirmative, the service should be reclassified as a Phase II service. Ambiguous answers require FCC consideration but must continuously compare the costs of maintaining regulatory constraints to the costs of untimely classification.

USTA's proposal to place services in a Phase II category—after an examination of the evidence on a geographic basis reveals and demonstrates that actual competition is present—is consistent with our economic analysis. USTA's trigger for placing a service in Phase II ensures that barriers to entry are sufficiently low so that new competitors would prevent incumbents from maintaining prices above competitive levels. An interconnection agreement coupled with actual use of facilities provides a sufficient basis upon which to determine that, in the case of a particular service in a specific geographic area, market forces are sufficient to constrain prices.

The 1996 Act and the Interconnection Order significantly eliminate or reduce the legal, regulatory and economic barriers to entering the local exchange and exchange access market. The sunk costs required to enter this market are significantly lower as a result of these developments, and the Commission should take this into account, and place the appropriate weight of such developments when deciding the amount of regulation needed for access services. As the Commission stated in its Interconnection Order:

> The Telecommunications Act of 1996 fundamentally changes telecommunications regulation. In the old regulatory regime government encouraged monopolies. In the new regulatory regime, we and the states remove the outdated barriers that protect monopolies from competition and affirmatively promote efficient competition using tools forged by Congress.[43]

In addition to the legal barriers that have been removed, the interconnection and unbundling requirements of the Act and the Order greatly reduce economic barriers to entry. The Act provides competitors with three paths of entry into the local exchange and exchange access market: (i) construction of new networks; (ii) the use of unbundled elements of the incumbent's network; and (iii) resale of retail services. This combined with the removal of operational barriers to entry has the effect of significantly reducing a competitor's sunk cost investment needed to enter the market. A state-approved interconnection agreement coupled with actual use of facilities is evidence that entry barriers are sufficiently low to discipline prices.

At this stage, it is appropriate for the Commission to examine competition from facilities-based carriers, those using unbundled network elements and those using a combination of elements and facilities. The appropriate geographic area will vary depending on circumstances but in general it will be no smaller than the exchange level. Determinations of actual competition do not follow a precise formula, however, evidence can be gathered to reach conclusions. This includes examining the number of competitors in the exchange area

[43]Interconnection Order ¶ 1.

and types of services being offered. In addition, measurements such as minutes of use being exchanged and number of NXX codes obtained by competitors are all appropriate measurements to consider.

Experience in the long distance marketplace shows that resale requirements aid facilities-based entry by affording competitors the ability to obtain customers and gain marketplace experience.[44] This enhanced the ability of competitors to obtain cash flow and deploy facilities after obtaining market share on a resell basis. While resale competition by itself is unlikely to capture the full benefits of dynamic competitive markets, it is certainly an effective tool that firms use in pursuit of facilities investment. As mentioned above, resale in the carrier access market must be viewed with a higher expectation than in a retail environment.

Under our analysis, by focusing on the degree of competition present, USTA's proposal is also likely to remove services from price cap regulation when they are facing actual competition sufficient enough to prevent the incumbent from maintaining prices above the competitive level. Not only will USTA's proposal ensure that barriers to entry are sufficiently low so that entry from new competitors would prevent an incumbent from maintaining price above the competitive level, but by focusing on the actual competition in the market additional protection is ensured.

b. Phase II Reforms

Removing services that conform to phase II conditions from price cap regulation allows market forces to constrain prices and provides for more efficient investment and consumption parameters. As stated above, regulation should substitute for market forces only when those forces are insufficient to discipline prices effectively. Phase II services, on the other hand, are disciplined by low entry barriers—principally through access to unbundled network elements—

[44]John T. Wenders, *The Economics of Telecommunications Theory and Policy*, Chapter 10, Ballinger Publishing Company, Cambridge, Massachusetts, 1987.

and highly likely to be disciplined by actual competition. USTA's proposal to examine services on a geographic basis provides additional protection that market forces will constrain pricing and price cap regulation for remaining services adds additional protections.

3. Forbearance

We also believe that there are services that meet the Act's requirement for the Commission to forbear. These services include directory assistance, special access, direct trunked transport and corridor services. Applying the Act's requirement reveals that entry barriers are sufficiently low and competitors are sufficiently present to discipline prices and ensure just and reasonable rates. Maintaining unneeded regulatory constraints raise incumbent costs relative to the entrants and distorts market outcomes. Properly-timed forbearance decisions reduce asymmetric regulatory constraints and provide for success based on a provider's efficiency. Having to file tariffs on 45 days' notice and provide full cost support raise costs and should be avoided if conditions warrant.

In the aforementioned markets, we believe conditions warrant forbearance. Entry barriers in these markets are low as can be seen by entrants into and success in these markets. By first quarter 1995 high capacity service losses to competitors were 39% in Philadelphia, 35% in Pittsburgh, 32% in Washington, D.C, 27% in Baltimore, 39% in Los Angeles, 37% in San Francisco, 50% in New York City and 37% in Boston. In addition, given the availability of collocation, it is reasonable to conclude that direct trunked transport substitutes are equally available where collocation by ILEC competitors is utilized.

The Commission recently classified AT&T—with a 58 percent market share in minutes of use and revenues—as a nondominant domestic MTS Carrier.[45] According to Bell Atlantic, its two main corridor routes are served by approximately 90 interexchange providers and roughly 90 percent of the potential customers in the corridors never use Bell Atlantic corridor

[45] *Motion of AT&T Corp. To be Reclassified as a Non-Dominant Carrier*, Order 11, FCC Rcd 3271 (1995).

service.[46] Finally, the evidence indicates that competition exists in the directory assistance market and that forbearance is appropriate. Incumbent LECs have lost wholesale directory assistance traffic to IXCs and alternative service providers and retail directory is also subject to competition from CLECs and new technologies.[47]

C. Safeguards

While granting regulatory flexibility and eliminating unnecessary regulatory constraints are sound economic policy, it is also proper for the Commission to guard against anticompetitive pricing. Price reductions can be deemed anticompetitive when lower cost, more efficient competitors would be disadvantaged and unable to compete in the face of such pricing tactics. While anticompetitive practices may in fact occur, modern economic theory considers such pricing to be generally unprofitable. Given proper safeguards and current regulatory constraints, such pricing practices are highly unlikely to occur. This point is especially important to keep in mind because when ambiguous results arise from market power analysis, the costs of continued regulation—likely market distortions—must be compared to the costs of untimely reclassification, generally equal to the net effects of anticompetitive behavior times the probability of occurrence.

1. Predatory Pricing

To be a successful competitive strategy, predatory pricing requires that three conditions hold: (i) the predator must be a dominant firm or likely to become one; (ii) market structure must allow later recoupment of funds invested in predation; and (iii) the predator must invest in the elimination of its competitor. Regulatory rules which eliminate barriers to entry and

[46] *Petition to regulate Bell Atlantic as a Nondominant Provider of Interstate InterLATA Corridor Service*, Petition, July 7, 1995, p. 2.

[47] Businesses rent or buy computer disks with telephone numbers instead of using directory assistance, Oregonian, September 27, 1996; and Excell, which was founded in 1994, has won contracts to provide directory assistance to AT&T in major US markets, The Arizona Republic, September 2, 1996.

prevent pricing below cost address these concerns. Recoupment is especially difficult in telecommunications because the underlying network of one's competitors remains in place after predation because of the sunk-cost characteristics of such facilities. Therefore, when a LEC raises prices in the future to recover its lost profits, the rival's network remains in place and can be used to discipline prices.

In general, the Courts have recognized that recoupment is difficult and have been suspicious of predatory pricing claims. As indicated in *Matsushita*:

> "the success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain...For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful."[48]

2. Cross-subsidization

Rate-of-return regulation provides the regulated firm with an incentive to misallocate costs—brought into existence as a result of providing a competitive service—to non-competitive services.[49] Under such a scenario, predatory pricing for a competitive service may be combined with an increase in prices or profits from a non-competitive service to offset the losses from predation. Price cap regulation, on the other hand, provides the well-known benefit that it reduces the ability and incentive of the regulated firm to cross-subsidize competitive services. A pure price cap plan—one where there are no earnings sharing provisions—has the effect of eliminating the ability and incentive of the regulated firm to cross-subsidize. Therefore, for those LECs which are under some form of price cap regulation, the ability and incentive to cross-subsidize is greatly reduced and the Commission should, accordingly, factor this into their decision-making process comparing the costs of prolonged regulation to untimely classification.

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[48] *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 1986, emphasis in original.

[49] *Superfairness,* Chapter 6.

3. Price Squeeze

The theory of predatory pricing applies as well to a vertically integrated firm that supplies an essential input and a downstream retail service.[50] A strategy of pricing the retail service below the sum of the incremental cost of the service and the foregone contribution (price less incremental cost) from the essential input is called a price squeeze, and if successful, it can have the anticompetitive effect of excluding a more efficient rival from the downstream market. With these prices, the integrated firm finds it more profitable to supply the essential input than the retail service, and the unusual circumstances in which such retail prices would be profitable are generally the same as those described above for predatory pricing and are unlikely to hold in telecommunications markets for the same reasons discussed above. There are three additional reasons why the Commission should not be concerned that LECs will engage in such price squeezes:

- rapidly increasing competition for access services is dismantling the bottleneck on which the success of this price squeeze strategy rests;
- as the Commission has recently noted, imputation requirements in the Act and the Commission's safeguards prevent a price squeeze from occurring;[51] and
- state and federal regulators ensure that the LEC does not receive monopoly profits to invest in a price squeeze.[52] The regulated mark-up on carrier access charges is much smaller, per minute, than the mark-up on IXC interstate long distance charges.

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[50] An obvious example in telecommunications is a LEC that supplies carrier access services on a monopoly basis and competes downstream in the retail long distance market.

[51] "The structural and nondiscrimination safeguards contained in section 272 ensure that competitors of the BOC's section 272 affiliate have access to essential inputs, namely, the provision of local exchange and exchange access services, on terms that do not discriminate against the competitors and in favor of the BOC's affiliate." FCC 96-489, *First Report and Order*, CC Docket No. 96-149, issued December 24, 1996, ¶ 13.

[52] It is impossible in a regulated setting to calculate monopoly profits on a service-by-service basis. As was discussed earlier in this affidavit, rate levels for access services, as well as most other telephone services, are the result of political judgments in addition to economic measurements of costs. Therefore, to refer to contribution in access prices as monopoly profits simply on the basis of the existence of such contribution is inaccurate and ignores the history of regulated rate-setting.

A second type of price squeeze strategy—one that imputation rules and safeguards cannot prevent—is sometimes alleged by incumbent IXCs. According to this theory, as long as access rates are priced above incremental cost and the LEC's access prices are regulated under a price cap with no earnings sharing, the LEC will have an incentive to price its interLATA service lower than it would if it were simply seeking to maximize profits from interLATA services. This occurs because the lower market price for interLATA services stimulates market demand, increases demand for carrier access service which increases LEC profits since carrier access is priced above incremental cost. In this way, the LEC behaves as if its effective access cost were not the tariffed or imputed access rate that its rivals face but rather it takes into account its actual incremental cost of access in pricing access and interLATA services.

If this incentive causes vertically-integrated LECs to lower their interLATA service prices, consumers clearly benefit from these lower prices. Indeed, to the extent that ILECs price access above incremental cost, welfare will be increased by any firm that prices long distance below its profit-maximizing level, given the level of access charges. That is, the welfare losses from pricing access above incremental cost are offset by any firm that prices long distance below the profit-maximizing level given the price of access. These price reductions only would raise competitive concerns to the extent that the LEC reduces its prices substantially below cost, in violation of imputation rules. While this dynamic may in theory give LECs an incentive to violate imputation rules, it certainly does not make it any easier to do so, and, as noted earlier, the Commission has concluded that its existing antidiscrimination rules, as modified pursuant to the Act, are sufficient to prevent such actions.

In addition, vertically-integrated LECs theoretically would only choose to price in violation of imputation rules and incur losses in the interexchange market in this way under very narrow conditions that are unlikely to occur in practice. The LEC's interexchange market share would have to be sufficiently large in order for its price reductions to affect the market price, but the larger the LEC's retail market share, the more interLATA revenues the LEC would forego through such a strategy. In other words, for this strategy to work to the LEC's

advantage, its interexchange market share cannot be either too high or too low. Also, the success of this strategy depends upon the elasticity of demand for interexchange service, the relative amount of contribution in access prices, and increasing competition for access services. Therefore, for a LEC to use this incentive to its advantage, it would have to: (i) price interexchange service in violation of imputation rules; (ii) fine-tune its prices to achieve just the right market share given the subtle interplay of price elasticity and contribution in access; and (iii) hope that its IXC competitors do not take advantage of alternative access arrangements in response to these actions. This is clearly a case where what may be a concern in theory, is not a concern in reality.

Finally, increasing competition for access services from facilities-based competitors and from the use of unbundled elements for access will make anticompetitive strategies impossible and unprofitable to undertake. Such competition—coupled with the Commission's existing and new anti-discrimination rules—will prevent anticompetitive behavior in the interexchange and carrier access markets during a market-based transition to efficient access prices.

IV. SUMMARY

We believe that USTA's proposals for transitioning access rates to more competitive levels and its approach of placing services in appropriate regulatory constraints are consistent with sound economics and provide for significant efficiency improvements. Allowing market forces to transition access rates to more competitive levels enhances economic efficiency and maintains the incentive-improvement regulations pursued by the Commission. A prescriptive approach is fraught with significant costs and risks which are unnecessary and a reversal of Commission policy.

USTA's proposal for lifting regulatory constraints is consistent with sound economics and it accurately takes into account the competitive nature of the market and provides sufficient protection to prevent the exercise of market power. A state-approved interconnection agreement is sufficient evidence that anticipated competition from potential new entrants will

develop. Because USTA's proposal for removing a service from price cap regulation is dependent on actual competition being present, it ensures that barriers to entry are sufficiently low.

In view of market conditions in the exchange access market, the 1996 Act, and the Order, regulatory reform is critical to the development of efficient and fair competition. Such developments require regulatory reforms in order for market forces to determine which firms provide the service. Granting the LEC's flexibility—combined with adequate safeguards—must not wait until after significant entry has occurred. Such an approach increases the likelihood of inefficient entry due to uneconomic bypass opportunities. Adequate regulatory flexibility must be permitted when competition starts, thus assuring that the most efficient provider prevails.

ATTACHMENT 2

"IMPLICATIONS OF THE SEPARATIONS LEGACY FOR IMPLEMENTATION OF THE TELECOMMUNICATIONS ACT OF 1996"

Affidavit of
James M. Fischer, Albert P. Halprin,
Henry M. Rivera and Marvin R. Weatherly

USTA Comments
CC Docket No. 96-262
January 29, 1997

Implications of the Separations Legacy for Implementation of the Telecommunications Act of 1996

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